

State Board of Equalization

OPERATIONS MEMO

For Public Release

No : 1112
Date : February 18, 2004
Revised : January 1, 2009

SUBJECT: Managed Audit Program

I. GENERAL

The Managed Audit Program (MAP) was reinstated effective January 1, 2004. With the passage of Assembly Bill 1043 (Chapter 87, Statutes of 2003), Article 2.5 (commencing with Section 7076) of the Revenue and Taxation Code was added to include new provisions for the MAP. This article authorizes the Board of Equalization (BOE) to determine which accounts are eligible for a MAP and allows the BOE to enter into a MAP Participation Agreement with eligible taxpayers. With the passage of Assembly Bill 3079 (Chapter 306, Statutes of 2008), section 7076.5 of the Revenue and Taxation Code was repealed to remove the January 1, 2009 sunset date, allowing the MAP to continue indefinitely.

The new MAP differs from the previous MAP as follows:

- Prepayment accounts may participate in the MAP.
- The BOE may grant relief of liability under Revenue and Taxation Code section 6596 in cases where taxpayers who have participated in the MAP rely on erroneous written advice from the BOE provided in the MAP audit and fail to pay amounts due.

II. BACKGROUND

A managed audit is essentially a self-audit. Under the direction of a BOE auditor, an eligible taxpayer is provided written and oral instructions to enable the taxpayer to perform the audit verification and prepare the working paper schedules necessary to complete a particular portion of the audit. The advantages to the taxpayer and to the state include the following:

- a. The taxpayer is less likely to take audit issues through the administrative appeals process or litigate audit findings;
- b. The auditor will spend fewer hours on the audit and fewer hours at the taxpayer's business;
- c. Questions of taxability are more likely to be resolved during the audit process;
- d. The taxpayer is likely to become more knowledgeable about how the sales and use tax affects his/her business;
- e. Because of the knowledge gained from the managed audit, future voluntary compliance is more likely for those areas the taxpayer has audited;
- f. The taxpayer will be more familiar with the audit process;
- g. A more cooperative, ongoing relationship with the BOE is likely to be established;

- h. Where a liability is disclosed, interest will be computed at one-half the normal rate; and
- i. Section 6596 relief may be provided in cases where taxpayers that have participated in the MAP rely on erroneous written advice from the BOE provided in the MAP audit and fail to pay amounts due.

III. ELIGIBLE ACCOUNTS

It is extremely important the auditor conduct a thorough review of the taxpayer's operations prior to proceeding into the managed audit process. While it is the auditor's responsibility to determine whether a taxpayer is eligible to participate in a managed audit, a taxpayer may initiate the review process by requesting a managed audit be conducted. For example, taxpayers seeking a tax clearance or who have been notified of an impending audit may wish to conduct a managed audit to expedite the clearance or routine audit process. Staff should consider all reasonable requests for participation, keeping in mind our primary goal is the efficient use of auditing resources and maximizing the effectiveness of the MAP. Districts must be able to clearly define the cost savings in staff hours that can be used to perform other productive audits. Accordingly, interested taxpayers should submit their request for participation to the appropriate District Administrator/District Principal Auditor. In their request, the taxpayer is required to clearly explain how he or she meets the statutory requirements of section 7076.1 and submit any information supporting the cost benefit.

Accounts that may be eligible for the MAP shall include those meeting all of the following criteria:

- a. Any person whose business involves few or no statutory exemptions;
- b. Any person whose business involves a single or small number of clearly defined taxability issues;
- c. Any person who agrees to participate in the MAP; and
- d. Any person who has the resources to comply with the managed audit instructions provided by the BOE.

Examples of situations in which a managed audit should not be used include cases where:

- a. The taxpayer's books and records are inadequate;
- b. The taxpayer has complex issues relating to the allocation or reallocation of local tax;
- c. The taxpayer is a business with inadequate achieved markups;
- d. The issues involved are very complex (for example, research and development contracts); or
- e. There is a question regarding negligence or intentional underreporting (fraud).

The eligibility provisions contain restrictive language. Staff should consider the taxpayer and/or representative's level of sophistication in understanding and dealing with any issues that may arise. Any inquiries regarding the eligibility of an account for the MAP should be sent by the District Principal Auditor to the Chief of the Tax Policy Division (with a "cc" to the respective Chief of Field Operations).

IV. APPLICATION OF INTEREST AND PENALTIES

A. Interest

If a tax liability is disclosed as a result of an approved MAP audit, the audit is completed, and the deficiency is paid timely pursuant to the MAP Participation Agreement, interest will be computed at one-half the normal statutory interest rate for the total unreported tax liability. The one-half interest rate will apply despite the fact that only a portion of the audit was performed under a MAP audit and even if the portion of the audit performed by the auditor results in a tax liability. For example:

An audit is conducted on a manufacturer whose only deduction is for sales for resale.

1. It is agreed the taxpayer will perform a managed audit of sales for resale and asset purchases. The managed audit discloses additional tax liability. This review would normally comprise a substantial portion of the audit if performed by the auditor.
2. A review of lease transactions is also necessary and is performed by the auditor. Additional tax liability is established. This portion of the audit is not deemed conducive to taxpayer review, and does not entail much expenditure of time by the auditor.

Under these circumstances, the entire tax liability would be computed at the one-half interest rate since there was a MAP Participation Agreement. If the BOE determines, under paragraph 10 of the MAP agreement, that the taxpayer fails to comply with the provisions of the agreement or fails to complete its portion of the MAP and the auditor finds it necessary to perform a significant amount of verification, the breach of the agreement by the taxpayer will void the MAP Participation Agreement, and the one-half interest rate will not apply. This will also be true if a negligence or fraud penalty is imposed during the audit period.

If the MAP audit results in a credit or refund, the standard running balance method will be used to compute interest. If the audit has both debit and credit periods, the one-half interest rate would apply for debit periods and the full statutory credit interest rate would apply for credit periods.

B. Penalties

There is no change to procedures for applying penalties as warranted under the MAP; however, if after their preliminary review of records, the auditor believes the taxpayer was negligent, a managed audit should not be conducted. A MAP should also not be used if the auditor believes there was fraud during the audit period.

V. DISTRICT OFFICE RESPONSIBILITIES

It is primarily the responsibility of the auditor to determine whether a taxpayer should be considered eligible for the MAP. The auditor's immediate supervisor is responsible for the approval of the auditor's recommendation. This information must be documented by the auditor in the Assignment Contact History (Form BOE-414-Z).

A. Preliminary Review

As part of the normal audit procedure, auditors will review the taxpayer's operations and determine whether the minimum eligibility requirements are met (as described in Section III of this Operations Memo) for the MAP. This includes a facility tour (if appropriate); a review of the chart of accounts, general ledger, federal income tax returns, sales journals, sales invoices, depreciation schedules, purchase invoices, sales and use tax returns, and reporting procedures; and an evaluation of the taxability of the sales and/or purchases. The auditor should also ascertain the taxpayer's knowledge and understanding of the tax laws applicable to the transactions being reviewed. In addition to the minimum eligibility requirements for the MAP, the taxpayer must also agree to perform a significant portion of the audit.

Audit staff may consider use of the Computer Audit Specialist to improve audit efficiency (reduce audit hours), if the account meets the criteria outlined in Audit Manual section 1304.40.

Following is an example of a taxpayer not eligible to participate under the MAP:

An audit is conducted on a manufacturer whose only deduction is for sales for resale.

1. After initial review of records, the auditor finds significant problems with the taxpayer's internal controls, missing sales invoices, and/or a total lack of documentation to support claimed sales for resale.
2. It is necessary for the auditor to perform the test of resales, and this will involve the expenditure of time similar to that on an audit.
3. During the review, the auditor finds that an examination of purchases subject to use tax will involve a minimal expenditure of time, and therefore the use of the MAP will not be an efficient use of auditing resources.

In this scenario, the taxpayer should not be considered for a MAP audit and receive the reduction in the interest rate because participation in a MAP would be of little benefit to the State in the reduction of audit hours.

B. Managed Audit Program Participation Agreement

After obtaining the supervisor's approval for eligibility, the taxpayer should be presented with Publication 53, *Guide to the Managed Audit Program*, which includes a copy of the *Managed Audit Program Participation Agreement*

(Form BOE-526). The provisions of the MAP should be explained to the taxpayer. If the taxpayer agrees to participate in the MAP, Form BOE-526 must be completed by the auditor with the following information:

1. Taxpayer's name and account number;
2. Audit period;
3. A reasonable time period (generally within 90 days) the taxpayer is allowed to complete the work. However, audit staff should use their discretion to accommodate larger business operations;
4. Information on the types of transactions and records to be reviewed; and
5. The method for review and the periods for the records to be reviewed.

This agreement will then be signed and dated by the taxpayer and the District Principal Auditor. A copy of the signed agreement will be provided to the taxpayer. The original signed agreement must be attached to the Headquarters' audit report packet with a copy retained in the audit working papers.

The BOE may void the MAP agreement for any of the following reasons:

- The taxpayer has failed to complete the managed audit by the due date in accordance with the provisions in this agreement;
- The taxpayer has refused to cooperate with the BOE during the verification process of the agreement or has refused to cooperate with the BOE if staff conducts an audit of any transactions not included in the agreement;
- Penalties for negligence or fraud or an intent to evade are imposed during any portion of the audit period.
- There is jeopardy of collection under section 6536; or
- The payment of the liability and interest was not made within the time period specified in the MAP Participation Agreement.

Before a MAP agreement can be voided by the BOE, a summary of the specific circumstances of the case and reasons for voiding the MAP must be provided to and approved by the respective Chief of Field Operations. If the MAP agreement is voided, the taxpayer will not be entitled to the interest computed at one half the statutory rate. The taxpayer's actions should be documented on Form BOE 414Z, and the taxpayer should be notified in writing by the District Principal Auditor that the MAP Participation Agreement is voided and terminated along with an explanation of the reasons. The front of the audit report should continue to be marked as a managed audit for program evaluation purposes with an explanation for the termination shown on the back of the audit report. The AUD MC screen in IRIS should also have the flag set to "N" for managed audit to prevent the reduction in the interest rate.

Participation in the MAP is voluntary on the part of the taxpayer. Withdrawal from MAP by the taxpayer should not have an impact on how the audit is completed or the scope of the audit verification to be performed by the auditor. The only impact is that the taxpayer will not receive the benefit of the interest computed at one half the statutory rate should the audit result in a tax liability.

C. Verification of Taxpayer's Examination

A very important factor for the success of the MAP is the verification of work performed by the taxpayer. While it may not be necessary for the auditor to check 100 percent of the work performed by the taxpayer, a review should be conducted to the extent the auditor is satisfied the work performed is substantially accurate. This verification should confirm the instructions provided to the taxpayer were accurately followed and any problem areas of taxability were sufficiently addressed. The taxpayer should also be instructed to separately maintain the records used in the examination (sales invoices, purchase orders, resale certificates, etc.) until the auditor's verification is completed.

D. Audit Comments

The verification comments should fully describe the procedures used by the taxpayer and by the auditor, including verification of the taxpayer's work by the auditor. In addition, comments should be made regarding any discussions with the taxpayer regarding areas of underreporting.

E. Audit Report

The audit report should be prepared by the auditor and transmitted using normal procedures; however, a notation should be made on the top right corner on the front page of the audit report indicating this is a managed audit.

F. District Audit Reviewers

The reviewer will ensure approved MAP audits are properly identified on the front of audit report, the AUD MC screen flag is set to 'Y' for managed audit, and interest is properly computed at the applicable rate. The reviewer should ensure the original signed MAP agreement is attached to the Headquarters' audit report packet with a copy retained in audit working papers.

G. District Reporting Procedures for Evaluating MAP Participants

Following each quarter, District Principal Auditors will submit to the Audit Support Unit (MIC 44) a report that evaluates completed accounts participating in the Managed Audit Program. The reports will also track those accounts not approved to participate in the MAP or any agreements that were voided by the BOE, along with an explanation. Refer to Exhibits A & B for sample report formats that include specific areas to be addressed. Reports should be submitted no later than 45 days after the end of the quarter.

VI. HEADQUARTERS RESPONSIBILITIES**A. Audit Determination and Refund Section**

The Billing Team will ensure the interest calculation and the “interest through date” are correct for all managed audits prior to billing. Once the audit report is approved for billing, a copy of the audit report and the MAP Participation Agreement will be made and forwarded to the Chief, Tax Policy Division.

There is no change to procedures for claims for refund for managed audits.

B. Audit Support Unit (ASU)

The ASU will coordinate and track data received from districts audits of taxpayers participating in the Managed Audit Program. Quarterly reports will be submitted from each district evaluating the impact of the Managed Audit Program on its participants in specific areas (Exhibit A & B).

C. Petitions Section

There is no change to procedures for filing timely petitions for managed audits.

VII. OBSOLESCENCE

This operations memo supersedes Audit Manual sections 0435.00 – 0435.20. This operations memo will become obsolete when the information contained herein is incorporated into the appropriate manuals.

Randie L. Henry
Deputy Director
Sales and Use Tax Department

Attachments: Exhibits A & B

Distribution: 1-D

Managed Audit Program Evaluation Report
Completed Cases* - Quarterly Report

				<u>Taxable Measure Per</u>				<u>Average Quarterly Measure of Tax Reported by Taxpayer</u>				<u>Audit Tax Liability</u>				Audit Protested (Y/N)	Reason for Participation, or Other Reason (i.e. not approved, voiced)
OMA	Case ID	Account Number	Taxpayer Name	Taxable Measure Understated/ Overstated	Areas Taxpayer Participated In Audit Work	(Non-Areas) Auditor Prepared Audit Work	Total Hours On Audit	Estimated Audit Hours Saved	Audit Period	Following Audit	Increase/ Decrease	Tax	Interest	Penalty	Total Tax, Interest & Penalty		
1																	
2																	
3																	
4																	
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34																	
35																	
36																	
37																	
38																	
39																	
40																	
Total																	

*Note: Please list any accounts that submitted a request to participate in the MAP but were not approved by the Board, or those accounts for which the Map Agreement was voided. A reason should be included in each of these cases

Managed Audit Program (MAP) Evaluation Summary

For the period of _____ through _____

District Name: _____

How many total audits did your district initiate? _____

How many MAP audits were completed? _____

How many MAP audits are in process? _____

Based on your experience, how effective is the MAP now that the statutory limitations on prepayment status and section 6596 relief have been repealed?

What are some recommendations for further improving the success of the managed audit program since its reinstatement?

Other comments:
